

- Technology is turning uneconomic reserves into attractive investment propositions.
- Investors from outside the oil and gas business are buying into the industry.
- For all investors, whether energy companies or private fund managers, good planning is essential.

## Tread carefully through the oil patch

The oil and gas business is booming thanks to technology, and outsiders are keen to invest. However, Greg Pollard of Ernst & Young warns that without doing the right research, such deals can fail.



THROUGHOUT THE HISTORY OF THE OIL AND GAS BUSINESS, PEAKS AND VALLEYS in commodity prices have had one thing in common: M&A activity so fast and furious that it is difficult to keep up with who is buying and selling. The dramatic rise of oil prices over the past few years has certainly fuelled this trend.

The current surge in oil and gas M&A activity began in late 2003, picked up steam in 2004 and boomed in 2005. According to data for 2003 from John S. Herold Inc, there were 597 transactions globally, with a total deal value of over \$94bn. For 2004, there were 770 transactions, representing a rise of 29 per cent, with a total deal value of \$146bn, up 56 per cent. For 2005, it reported 840 transactions, up 9 per cent, and a deal value of \$257bn, up 75 per cent.

High prices, balance sheets full of cash, easy access to multiple forms of inexpensive capital and tremendous pressure to fund acquisition and drilling activity can tempt all but the most disciplined companies to pursue deals without fully evaluating the risks or understanding the complexities of today's M&A environment.

### Technology changes everything

The current deal boom differs from those of prior periods in distinct

ways, allowing buyers to be more aggressive than ever before. Companies that are buying, selling or thinking about trading should be aware of these new twists as they navigate their way through the oil patch M&A environment.

Perhaps the most significant difference between the current and past deal environments is the impact technology is having on deal economics. The sophistication of three-dimensional seismic, horizontal drilling and other high-tech processes can make uneconomic properties viable again. Combine this phenomenon with high commodity prices and there are more reserves worth buying now than ever before. As a result, lean, technologically sophisticated exploration and production (E&P) companies have a distinct advantage when acquiring properties with undeveloped reserves.

Cost-effective independents, flush with cash and armed with enhanced oil-recovery techniques, have been snapping up easy-to-drill, highly developed assets abandoned by the majors in pursuit of more difficult, exotic and expensive locations.

### Educating the new players

Another striking difference between the deals of today and those in the past relates to the participants. The enormous interest and participation in oil and gas transactions by private equity players, leveraged buyout funds and hedge funds is a new phenomenon.

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Historically, there have been two reasons private equity players have avoided the oil patch. First, they were not needed, as most oil and gas companies of any size had ample access to the public equity markets. Second, private equity funds traditionally avoided the oil and gas business because of the commodity price risk.

However, the belief that high prices are here to stay has convinced some of them to take the plunge. And the ability to hedge and lock in those higher prices in energy markets that are far more liquid and

transparent than 20 years ago has quelled much of their uneasiness. For oil and gas company executives, this necessitates educating a new class of investors on the workings of the industry, with its unique vocabulary, technology, accounting and tax issues, and regulatory environment.

68 Typically, these arrangements have proved to be mutually beneficial. Professional investors gain quality operations run by experienced management teams and in turn they bring a high level of financial sophistication to the industry. It takes only a quick look at the balance sheets of E&P companies to note the third distinguishing factor of the current deal boom. Many are experiencing the healthiest balance sheets they have had in years. Swimming in cash from high commodity prices, many oil and gas companies have been paying down debt aggressively, leaving them poised to take advantage of attractive opportunities quickly.

### Look before you leap

Historians tell us of the pioneers of 1949 who were so eager to get to California for the Gold Rush that they neglected to plan adequately for their journeys west. As a result, some ran out of water in the middle of the Nevada Desert and ended up paying as much as \$100 – in mid-1800s dollars – for a glass of water. While the treasure that oil and gas companies seek these days is black rather than gold, they can learn some valuable lessons from the explorers of '49. Namely, know the territory you are traversing and plan accordingly.

### Failure to identify inadequate financial and operational controls before a transaction can have disastrous consequences in the long run.

The reality is that many mergers and acquisitions fail to achieve their anticipated benefits, no matter what the industry. One common reason is that the parties overestimate those benefits in the first place. Veteran oil executives, when considering or pursuing a deal, are sometimes lured into thinking that they know a company and its assets so well that they rely on rules of thumb rather than on delving into the details – where, as the saying goes, the devil resides.

Skimping on comprehensive due diligence – whether performed by qualified internal staff or outside advisors – leads to overestimating the synergies of a deal, which manifests itself in overpaying. Yet some companies view all but basic due diligence as an unnecessary delay.

Another reason many mergers fail is the absence of detailed post-merger planning and implementation. Often, players are so focused on structuring the deal's financing and completing it that little thought is put into how the combined company will operate once the papers are signed. It is the 'what do we do now?' syndrome.

Yet financing and structuring the deal are usually the easy parts, particularly in the current environment with capital so readily available. Making it work is the hard part. The topics to be addressed are almost limitless. How will the organisation be structured? What IT systems will be used for finance and operations? How will compensation be determined?

### Lining up the right resources

These two common pitfalls underscore the need for professional, experienced advisors for both due diligence and post-merger planning and implementation. This counsel does not necessarily need to come from the outside. Some companies have sophisticated and experienced in-house accounting, finance and legal staffs that can plan and execute large and complex transactions.

However, many do not, and even those that do have likely assigned a large portion of their in-house resources to implementing the requirements of Sarbanes-Oxley Section 404. Even relatively small transactions can take at least six months from concept to closure, and many corporate staffs are stretched thin during a time of increased M&A activity and opportunity. Whatever capability resides in-house, bringing in outside expertise is usually well worth the expense. That is especially true now, when it is increasingly important to understand not only the value of a target company's assets, but its financial and operational control environment as well.

Energy firms tempted to 'go it alone' in evaluating acquisition opportunities should note that private equity firms – which are actively making acquisitions – partner with outside professional advisors for due diligence. When choosing an outside advisor, it is important to consider industry knowledge. Transaction advisors should understand the nuances of the worldwide energy business. When pursuing international deals, an international scope and presence in the world's major energy centres – along with expertise in local capital markets, finance and accounting rules, tax laws and regulatory environment – are essential qualifications of an advisor.

Analysts expect the strong consolidation trend to continue in 2006, although perhaps at a slower pace if commodity prices continue their upward trajectory and the number of quality assets diminishes. So more deals are almost certain to come. Understanding the unique characteristics of the current environment, undertaking careful planning and analysis and seeking experienced counsel along the way could mean the difference between a deal that flops and one that delivers what it promises – and even more. ●

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